QKL Stores Inc.
First Quarter 2010 Earnings
May 17, 2010

Operator: Good day and welcome to the QKL Stores First Quarter 2010 Earnings conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mr. Bill Zima, ICR. Please go ahead, sir.

Bill Zima: Thank you, everyone, and welcome to QKL Stores First Quarter 2010 conference call. On our call today is Mr. Zhuangyi Wang, Chairman and Chief Executive Officer; Mr. Alan Stewart, Chief Operating Officer; Ms. Crystal Chen, Chief Financial Officer; and Mr. Mike Li, Investor Relations Officer. Mr. Li will translate for Mr. Wang this morning.

Before we begin, I would like to remind everyone that, except for historical information, statements made during this conference call are forward-looking and made pursuant to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties which may cause the Company's actual results in future periods to differ materially from forecasted or expected results. Those risks include, among other things, the competitive environment in the industry in general and in the Company's specific market areas, inflation, changes in the cost of goods and services, and economic conditions in general and in the Company's specific market area. Those and other risks are more fully described in the Company's filings with the SEC.

Mr. Wang and Mr. Stewart will discuss highlights of the Company's business during the first quarter of 2010. Ms. Chen will provide you with financial highlights as well; and then we will hold a question and answer session.

With this said, I would now like to turn the call over to Mr. Wang. Please go ahead, sir.

Mike Li: (Chinese spoken).

Zhuangyi Wang: Okay. (Chinese spoken).

Mike Li: Thank you, Bill, and good day, everyone.

Zhuangyi Wang: (Chinese spoken).

Mike Li: I'd like to thank everyone for taking the time to join us for today's conference call.

Zhuangyi Wang: (Chinese spoken).

Mike Li: Once again, we are pleased to report that we have continued our track record of consistent revenue growth and profitability this quarter.

Zhuangyi Wang: (Chinese spoken).

Mike Li: Our encouraging results demonstrate our leading retail position in northeast China, as well as our ability to execute our strategic initiatives.

Zhuangyi Wang: (Chinese spoken).

Mike Li: We were pleased with the increase our quarterly same-store sale results by 9% in the first quarter.

Zhuangyi Wang: (Chinese spoken).

Mike Li: All three of our core categories, grocery, fresh food, and non-food, experienced health levels of growth, and we benefited from the growing number of available products in each category.

Zhuangyi Wang: (Chinese spoken).

Mike Li: All three categories generate a lot of—generate a lot of growth for us.

Zhuangyi Wang: (Chinese spoken).

Mike Li: We have also made continued efforts to focus on the enhancement of our customer marketing initiatives and improved our specialized employee training program.

Zhuangyi Wang: (Chinese spoken).

Mike Li: Growing our margins and improving our profitability remains an important area of focus for the executive management team.

Zhuangyi Wang: (Chinese spoken).

Mike Li: The opening of our new distribution center in Harbin in late April will provide us with multiple opportunities to increase our scale and maximize our profit performance.

Zhuangyi Wang: (Chinese spoken).

Mike Li: We have a lot of…

Zhuangyi Wang: (Chinese spoken).

Mike Li: We have a lot of exciting initiatives in place, will allow us to generate greater value for our customer, as well as further drive our profits going forward.

Zhuangyi Wang: (Chinese spoken).

Mike Li: Our goal is to establish QKL Stores as the leading supermarket chain in the northeast China region.

Zhuangyi Wang: (Chinese spoken).

Mike Li: We are well on our way with the right contracts, product offering, and highly knowledgeable management team to execute our (inaudible) plan to propel QKL Stores into regional market leadership.

Zhuangyi Wang: (Chinese spoken).

Mike Li: I thank you all for your help.

Zhuangyi Wang: (Chinese spoken).

Mike Li: At this time, I would like to turn the call over to our Chief Operating Officer, Mr. Alan Stewart, and our Chief Financial Officer, Ms. Crystal Chen.

Zhuangyi Wang: (Chinese spoken).

Mike Li: And they will discuss the Company's first quarter financial highlights and strategic initiatives with you further. Thanks.

Zhuangyi Wang: Thank you.

Alan Stewart: (Inaudible), Zhuang. We opened two new stores during the first quarter compared to no stores in the prior year's period, first period. Our 35th retail store opened on March 24 in Tongjiang, Heilongjiang Province, which is upon the—near the Russian border. It is a hypermarket with floor space of approximately 6,200 square meters. We opened our 36th retail location on March 31st in Daqing, Heilongjiang Province. This was a supermarket with a total floor space of approximately 2,655 square meters. Each of these new stores carry items in all three of our core product categories, grocery and non-food. These two new stores bring our current store total to 36 supermarket/hypermarket locations and two department stores for a total of 144 square meters—for 144,000.

In April, we opened up one new location which I just want to comment on. We also temporarily closed a store at the same time (audio interference) in Jian, Ji Lin Province. This was an acquired property and after we opened the store, we realized (audio interference) renovations needed to be done. (Audio interference) decision to simply close (audio interference) and completely renovate and reopen the supermarket (audio interference). We're making good progress (audio interference) department store, including the supermarket, to open back up in July of this year. We consistently stand on (sp?) our performance of our existing stores and like to point out that none of our stores are closed to date due to subpar performance.

We remain on plan to open roughly 20 retail locations, having an aggregate of over 100,000 square meters this year. These locations will consist of supermarkets, hypermarkets, and department stores. We expect to have a total of five stores open in the first half, with the remaining 15 expected to open in the second half of the year. Our new stores under construction are scaling larger due to our regular assortment of grocery, fresh and non-food items. As our growing base of customers becomes more selective about food freshness and demands greater product variety, our stores provide a unique experience for our customers' growing product needs. We are confident that these efforts will drive our sales growth and generate higher sustainable gross margins for each store unit over time.

Our sales mix of grocery, fresh food, and non-food items this quarter was fairly similar to the prior quarters. For the first quarter, fresh food generated 47.8% of revenue; grocery, 35.5% of revenue; and non-food contributed 16.7 of revenue. Fresh food and non-food items continued to have the strongest performance from an overall profit standpoint. Private label sales in the first quarter contributed 5% of revenue. The total number of private label SKUs have grown to over 500 and with this growth, we believe that the private label sales can represent roughly 7% of sales this year and close to 20% over the next several years. As this increases, so can our gross margin.

We officially opened our new distribution center in Harbin on April 26. This new facility is critical to our growth strategy moving forward. Our new distribution center provides us with many benefits. First, it allows us to purchase non-food and grocery items directly from the manufacturers, thereby eliminating distributor costs. Second, we can expand small and large quantity purchases from farmers for fruits and vegetables and even make fruit purchases outside of our operating reach. Third, our new distribution center allows us to better manage inventories of private label products across our stores, allowing us to expand our number of private label offerings which we think can grow roughly 35 to 40% to over 700 before the end of the year. The distribution center is now handling shipments to all of our existing stores and can support up to our 200 store locations without any effort. We believe that the cities of our new store locations we plan on opening this year are not currently being targeted by larger international retailers. Being well capitalized and having a first mover advantage will allow us to strengthen our retail position in the northeast China region.

We have the right plan in place to drive our revenue and profit growth for this year and beyond. We will continue to open new stores in new strategic locations. At the same time, we are focused on improving our profitability by making more direct purchases from grocery and non-food manufacturers, as well as the resource buying in fruit, vegetable and fish product. We also plan on increasing our sales attributable to higher margin products like non-food and private label items. Our new DC we recently set up will allow us to realize many of these preceding goals.

As a result of our efforts, we are adding to a growing base of loyal customers, as demonstrated by a 9% same-store sales increase this quarter. We hope to draw more shoppers to our stores by offering membership sales and buying card sales, which improves loyalty and drives purchases. We plan to expand our marketing initiatives through promotional offers and advertising mailers.

We are pleased with our progress thus far in 2010 but still have a lot of work to do. Market conditions, including growth in northeast China, continues to be (inaudible). Northeast China is a resource-rich area with rising per capita disposable spending power. Further, our market opportunity is untapped. There are over 230 small and medium sized (inaudible), many of which have minimal exposure to large domestic and foreign supermarket chains.

At this time, I will turn over the call to Crystal, who will review our financial results for the first quarter.

Crystal Chen: Thank you, Alan. Revenue in the first quarter of 2010 increased 22.6% to 82.3 million from 67.1 million in the first quarter of 2009. Our revenue performance reflected the growth in existing stores, as well as our ongoing expansion of new stores. The 28 comparable stores, which are stores that have been open for at least one year, generated sales of approximately 68.7 million in 2010, an increase of $5.8 million or 9% compared with sales of 60.9 million in the first quarter of 2009.

Sales from seven new stores opened since January the 1st, 2009, were approximately $12 million in the first quarter of 2010. Gross profit increased 23.4% year-over-year to $14.5 million from $11.8 million the prior year period. Gross margin increased 7% from 17.5% in the prior year period due to the increase in sales in the year 2010 first quarter. We continue to believe that gross margin will be in the range of 17% to 19% over the next few quarters.

Operating income increased 7.7% to $5.5. million from $5.1 million in first quarter of 2009. Salary expenses increased 32.3% to $6.9 million or 8.3% of total revenue from $5.2 million or 7.7% of total revenue in the prior year period, resulting from increased salary, depreciation and rental expenses commensurate (sp?) with our expansion.

G&A expense increased 46.5% to $2.2 million or 2.6% of total revenue from $1.5 million or 2.2% of total revenue in the prior year period. Excluding a non-cash stock compensation expense of approximately $0.6 million recognized in the first quarter of 2010, general and administrative expenses was down to—was down to 1.9% as a percentage of revenue, reflecting operating average on higher revenue.

Net income for the first quarter of 2010 increased 11.9 million or $0.29 per diluted share from $4 million or $0.13 per diluted share in the first quarter of 2009. Excluding changes in the fair value of warrants for year 2010 and 2009 first quarter periods, adjusted net income for the first quarter of 2010 increased 11% to $4.1 million or $0.10 per diluted share from 3.7 million or (audio interference) in the prior year period. The number of shares in the computation of diluted earnings per share increased 34.5% to 40 million shares and 30 million shares, respectively, (inaudible) the public offering of 39.7 million in year 2009. The accounting treatments of the warrants resulted from a provision providing anti-dilution protection to the warrant holders, which was permanently waived by the warrant holders effective March 24th, 2010. As such, there will be no non-cash charges relating to changes in fair value of warrants the second quarter of 2010.

Balance sheet and cash flow – as of March 31st, 2010, we had $46.5 million in unrestricted cash compared to $35.9 million as of December 31st, 2009. Note that our bank loan and cash flow from our (audio interference) $1.5 million were up 2010 compared to $7 million first quarter of 2009. The decrease in cash provided by operating activities (audio interference) increase of other receivables, payables and customer receipts received, offset by a decreased level of inventory after the Chinese New Year. The increase in other receivables mainly resulted from lending money to vendors in the amounts of $11.9 million to ensure adequate level of merchandise for the Chinese New Year peak season.

Net cash used in investing activity was $0.9 million in the first quarter of 2010 compared to $1.5 million used in the first quarter of 2009, reflecting the opening of fewer stores compared to the prior year period. There was no cash flow associated with financing activities during the first quarter of 2010 compared to cash out (audio interference) quarter of 2009.

This concludes our prepared remarks. We appreciate you listening to our call and look forward to providing you (audio interference) to our business in months ahead.

Operator, we are now ready to take some questions.

Operator: Thank you. The question and answer session will be conducted electronically. If you would like to ask a question, please do so by pressing the star key, followed by the digit one on your touchtone telephone. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, to ask a question, press star, one; and we'll pause for just a moment.

Our first question comes from Howard Zhou with Roth Capital Partners.

Howard Zhou: Hello, everyone. (Chinese spoken). Yes, congratulations on another good quarter. My first question is regarding the new store opening plan. So you opened up two in the first quarter and that remains, according to you, the Company's plan; there are another 18 stores to open in the next three quarters. So just want to have a little bit more sense of, like, how comfortable you are with this target? Or in other words, how many stores you already finalized with, or they are ready to be taken over, and how many currently under negotiation? Can anyone talk about it?

Alan Stewart: Let me answer that, Howard, briefly. We're working on 27 locations, of which about six are signed, and that's on the supermarket/hypermarket. We are working on six in the department stores, of which all except one of those is signed. And so I'm very, very comfortable that we will open in excess of 20 locations before the end of the year, and I will publish those when all of them are signed for (inaudible). I don't want somebody coming in behind me and taking a location that we've been working on and negotiating if I publish it. I think it serves our—in our best interest to publish that also because we're looking for employees, we're looking for everything else to help us.

Howard Zhou: Okay, great. So, Alan, just want to make sure I understand correctly. So basically you're saying six hyper or supermarkets already signed and you're working on six department stores and one of them already signed. Is that correct?

Alan Stewart: Sixteen.

Howard Zhou: Sixteen?

Alan Stewart: That's of supermarkets, right.

Howard Zhou: I'm sorry, it's kind of on/off. Could you repeat again?

Alan Stewart: Okay. In the supermarkets, we have already signed 16 locations for 2010.

Howard Zhou: Right.

Alan Stewart: And in some of those locations, a few of them will go into 2011, like (inaudible) and (inaudible), okay? Those are already signed.

Howard Zhou: Okay.

Alan Stewart: And the rest will be signed to fill out the rest of 2010 in the supermarket.

Howard Zhou: Okay, thanks. And then next question is, the same-store growth came in at 9.2% year-over-year, so do you think you can maintain at least that kind of growth, or maybe even increase a little bit going forward?

Alan Stewart: I think it will be in the 9, 10, 11 range for the second quarter.

Howard Zhou: Okay, good. And then does management have any guidance for second quarter?

Alan Stewart: I don't think at this (audio interference), unless Crystal has—I don't—you know, we're on track with budget. Everything looks okay, just that these new stores are running a little bit late. And it was a terrible winter in China, everybody saw that.

Howard Zhou: Mm-hmm, okay. Okay, thanks for taking my questions. I will go back in the queue for now. Thanks.

Operator: Once again, to ask a question, press star, one. We'll hear again from Howard Zhou with Roth Capital Partners.

Howard Zhou: Okay. Yes, just two parts (sp?) of follow-on question, then. So, Crystal, could you—what did you say about the non-cash stock compensation in your G&A which caused the increased for the quarter? How much was it?

Crystal Chen: That is 7 million.

Howard Zhou: Seven million?

Crystal Chen: Yes.

Howard Zhou: For the first quarter?

Crystal Chen: Yes. I think that's all because we signed a waiver on March 24th, 2010, so from now on, there won't be any.

Howard Zhou: Okay. Well, I'm actually talking about stock-based compensation. It's not a warrant.

Crystal Chen: For the stock (inaudible).

Howard Zhou: Yes, in the G&A, yes.

Crystal Chen: Okay, it is—it's (inaudible).

Howard Zhou: Hello?

Crystal Chen: Get the number—the number is 570,000.

Howard Zhou: Okay, thank you. And so the gross margin was at 17.6 million. Do you think it will stabilize around this level after recent accounting reclassification? And do you expect your new—what kind of improvement we should expect from your new distribution center for the rest of the year?

Alan Stewart: I think, Howard, as I have mentioned before, I'm still—I'm comfortable with the 17.7, and I'm working with BDO to make sure that all the classifications are correct. But in addition, the center will give us about another 2% on purchases through that (audio interference), and that will ramp up. We're getting as much as 10% from some of the vendors, but because we're starting out with about 3,000 SKUs, we'll build to 6,000 in the next six months, it's going to take a little bit of time. But I'm confident that that's going to help us with at least 2%.

Howard Zhou: Okay, great. Thank you. Thank you, Alan.

Operator: Next we'll hear from Marty Simcrest (sp?) with—that is a private investor.

Marty Simcrest: Good morning, gentlemen, Crystal. Great quarter. I just want to go back to one question that the previous caller had. The $570,000 quarterly charge non-cash, is that recurring charge or is that a one-time charge?

Crystal Chen: It's a one-time charge.

Marty Simcrest: So if you take the $4,081,000, you can add that back in to sort of compare quarter-over-quarter, so you're over 4.6 million in income adjusted versus 3.6 million for the prior year's quarter, if I read that correct, which is about a 27% increase from the 2009 first quarter 2010. Is that correct?

Crystal Chen: I think that net income without the—the non-GAAP net income was about 4 million.

Marty Simcrest: Right, but you—but if you take that $570,000 stock option, you add it back in because it's a non-recurring one-time charge, that would increase it to over 4.6 million. Is that correct?

Crystal Chen: Right, and it would become 4.8 million—right.

Marty Simcrest: Right. That's what I'm trying—that's what I'm trying to say, Crystal. The numbers are—if you take that out, are significantly higher.

Crystal Chen: Right.

Marty Simcrest: That's the only point I'm trying to make. And, Alan, looks like margins are doing great and—like you had said, and I look forward to seeing the increased margins as the distribution center kicks in. So thank you all very much.

Alan Stewart: I appreciate it, Marty.

Crystal Chen: Thank you, Marty.

Operator: And it appears we have no further questions at this time, so I'd like to turn the conference back over to management for any closing comments or remarks.

Alan Stewart: I'd just like to thank everybody for your support and for tuning in this morning, and I look forward to updating you. I know that the new stores are a concern for everybody. I am confident that we are going to make our goal, and I've been pushing on it every day. We'll publish a list shortly when we have signed about five or six more locations, which some of those will be signed, or most of those will be signed before the end of this month. So, again, it serves in our best interest to publish that because it helps us get employees, it helps also the suppliers understand what we're trying to accomplish. So I don't have any problem, but I don't want to sign it until I can get them under contract. So thank you very much.

Operator: Once again, this does conclude today's conference. Thank you for joining.